Effect of Tax Morale on Value Added Tax Compliance Among Medium Taxpayers in North of Nairobi Tax District, Kenya

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Abstract

Purpose: Tax compliance is important as it has a direct impact on revenue for most governments around the world. Despite the reforms that the Kenya Revenue Authority has been undertaking to increase revenue collection, it has of late failed to meet its revenue targets, particularly VAT targets. There has also been existence of fluctuations in VAT collection over the past couple of financial years. The objective of the study is to showcase the effect of tax morale on Value Added Tax compliance among medium taxpayers in north Nairobi tax district, Kenya. The study has been guided by the ability to pay theory.

Methodology: The study adopted the explanatory research design and primary data was collected using structured questionnaires with closed-ended questions. The total target population was 2,376 VAT-registered medium taxpayers in north of Nairobi tax district, Kenya and the sample size was 342 respondents. Out of the 342 respondents targeted, 274 questionnaires were correctly filled and returned, indicating 80% response rate.

Results: The study also found that tax morale had a positive and significant effect on Value Added Tax compliance $\beta=0.173$ p-value =0. 016.

Conclusion: The study recommends that the government of Kenya should allocate resources towards improving taxpayer services, including helplines, online portals, and advisory services.

Keywords: *Medium Taxpayers, Tax Morale and Value Added Tax Compliance*

1.0 Introduction

The revenue collection in Kenya is a mandate which is administered by the government of Kenya and the Kenya Revenue Authority has been appointed and assigned that duty by an act of parliament. The Kenya Revenue Authority was formed on July 1st, 1995 by an Act of parliament as the government agency responsible for administration and collection of taxes on behalf of the Government of Kenya. The KRA receives the revenue and channels it to the Treasury which allocates the revenue to different sectors of the economy after the National budget is approved by Parliament and also the parliamentary budget committee (Kenya Revenue Authority, 2015).

Value Added Tax is a multi-stage consumption tax charged on the sale of goods and services at all stages of production and distribution chains. The tax is charged on the supply of taxable goods or services in Kenya and the importation of taxable goods or services in Kenya. The tax is collected by registered traders and remitted to Kenya Revenue Authority, but the burden is shifted to consumers through higher prices. Value Added Tax is charged under the VAT Act Cap 476 under the laws of Kenya. Tax compliance is a process in which taxpayers adhere to the rules set by the relevant tax authorities such as payment of taxes due and filing of returns so that revenue can be collected effectively. VAT was introduced in Kenya in 1990 as a means of increasing government tax collections by widening the tax base.

Tax morale refers to the intrinsic motivation of taxpayers to comply with tax obligations, influenced by factors such as social norms, perceived fairness of the tax system, and trust in government institutions (Torgler, 2020). Tax morale has been mentioned in literature during a study of "School of Tax Psychology" (Schmölders, 2022; Strümpel, 2021). This concept was used to explain the reasons why individuals decide to pay taxes from their psychological point of view. They tried to stress that paying taxes is not only an economic phenomenon but must not be taken into consideration only from the legal point of view. They focused their research on a different approach, compliance, and noncompliance of the tax system.

A medium taxpayer generally refers to a business or individual whose tax liability and income fall between small and large taxpayers in a country's tax system. The classification is often used by tax authorities to apply different levels of scrutiny, compliance requirements, or support services based on the taxpayer's economic size, (Giulia and Fabrizio, 2019). In many tax jurisdictions, taxpayers are grouped into categories like small, medium, and large, based on criteria such as turnover, income, or asset size. A medium taxpayer might be defined as one whose annual turnover exceeds the threshold for small businesses but does not reach the higher threshold reserved for large taxpayers, Traxler (2020).

1.1 Problem Statement

Compliance with taxation laws, VAT tax compliance, is a major concern for all tax authorities and it is not easy to have all taxpayers comply with the tax requirements (James and Alley 2020). Good tax compliance rates guarantee the government the much-needed revenue to finance the planned activities. Non-compliance denies the government the required revenue, OECD, (2021). This denies revenue from many governments over the globe making them unable to meet budgetary allocations and provision of essential services to their citizens. This has forced the governments to resort to external borrowings to finance their activities. In most instances, taxpayers are not willing to register for tax obligations, compute the correct tax due, filing returns on time, and payment of taxes due within the stipulated time (Dwenger, 2022)

In the US, it is estimated that the extent of tax gap (the difference between taxes owed and taxes filed) for 2021 was US$ 353 billion (IRS, 2022). This concern is particularly severe for developing countries given the rapid growth of investment in their economies and their lack of adequate experience in dealing with this problem. In China, the tax evasion by MSMEs resulted in revenue loss that amounted to US$ 3.88 billion each year. In Hong Kong, the Inland Revenue Department reported that about US $ 1.15 billion was collected from 2019 - 2022 back tax and penalties from MSMEs (IRD, 2023).

Several amendments have been made to VAT law in Nigeria, the most recent of which resulted in a 50% rate rise (from 5% to 7.5%), sparking ferocious arguments among a number of interest groups. Only businesses that make taxable supplies up to 25 million are obligated to charge, collect, and remit VAT as well as submit monthly VAT returns to Federal Inland Revenue

Services (FIRS), according to the Finance Act, 2020 (ICAN, 2022). Thus, it is expected that many SMEs may not meet the 25 million taxable supply threshold and, as such, should be exempted from VAT compliance obligations.

2.0 Literature Review

2.1 Theoretical Review

An expansion of the Theory of Reasoned Action (TRA) is the Theory of Planned Behavior (TPB) (Fishbein & Ajzen 1975, Ajzen & Fishbein 1980). Both theories are predicated on the idea that people assess the information at their disposal and use reason and logic to decide which behaviors to engage in. The desire of the individual to do a behavior (which is impacted by the value the individual places on the behavior, how easy it is to accomplish, and the opinions of others) and the belief that the behavior is under his or her control govern the behavior's performance.

The Theory of Reasoned Action (TRA), which contends that three factors—attitude, subjective norm, and perceived behavioral control—determine human action, was expanded upon by Ajzen (1991) and named the Theory of Planned Behavior (TPB). Subjective norm refers to one's comprehension of social pressure or expectation to perform or avoid performing a certain behavior; attitude is one's positive or negative assessment of carrying out a particular behavior; and perceived behavioral control is one's perception of how easy or difficult it is to carry out a given action, which is influenced by opportunity and resource availability (Taing & Chang, 2021).

The TPB holds that these three variables affect a person's intention to carry out a particular behavior, which in turn influences the behavior itself. It also presupposes that intention is a more accurate indicator of behavior when the behavior is volitional, or when the person has total control over the behavior. The TPB has been extensively used in a number of social psychology domains, such as tax compliance studies. According to a study by Taing and Chang (2021), employed the TPB to explain how taxpayers' intentions and behavior are influenced by their attitudes, subjective norms, and perceived behavioral control. They discovered that taxpayers who have favorable attitudes toward taxes, strong social norms supporting tax compliance, and a strong sense of control over their tax affairs are more likely to comply with their tax obligations.

2.2 Empirical Review

2.2.1 Tax Morale

Tax morale affects the interplay between trust and power. However, this work uses tax morale as a proxy of overall tax compliance and focuses on the effect of tax morale, education, and political/democratic rights on the interplay between trust and power. Indeed, a high level of tax morale does not necessarily imply a high level of (overall) tax compliance, since tax morale, unlike tax evasion, does not measure individual behavior but rather individual attitude.
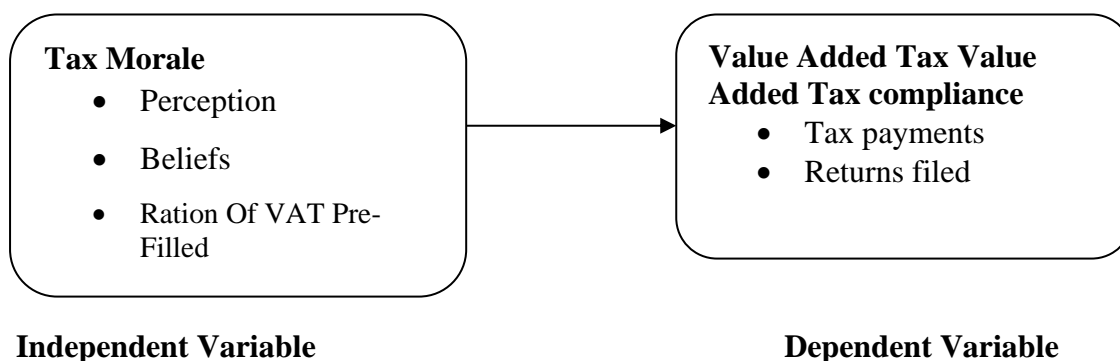
Ahmad *et al.* (2020) conducted a study on the determinants of tax morale: survey evidence from undergraduate students in Malaysia. The study variables included perception of tax morale among accounting and non-accounting students. The study used an adapted survey questionnaire from previous literature using the data collected from undergraduate students. The data was measured against a four-point Likert scale. The findings of the study showed that tax rate, fair tax system, government spending, corruption in government, taxpayer financial constraints, and religion influence the student's perception of the level of tax morale.

Fischer and Schneider (2019) show that tax morale affects the interplay between trust and power. However, this work uses tax morale as a proxy of overall tax compliance and focuses on the effect of tax morale, education, and political/democratic rights on the interplay between trust and power. Indeed, a high level of tax morale does not necessarily imply a high level of (overall) tax compliance, since tax morale, unlike tax evasion, does not measure individual behavior but rather individual attitude.

Horodnic (2019) conducted a study on tax morale and institutional theory: a systematic review of factors that shape tax morale across United Kingdom. The study adopted systematic search using a library catalogue which provided access to more than 400 databases. The findings of the study showed that the theory of tax morale has several factors that can identify with tax morale except for the control variables and socio-demographic factors. The study found that the most salient factor is trust, with both vertical and horizontal trust positively related to tax morale. Based on the empirically reviewed literature, it is evident that tax morale is determined by a myriad of factors that can generally be considered intrinsic human behavior. The study looked at perception and beliefs as some of these intrinsic factors.

2.3 Conceptual Framework

Conceptual framework is a visual pictorial diagram that gives a clear inter-relationship between independent and dependent variables of the study (Mugenda & Mugenda, 2003). The conceptual framework shows how the independent and dependent variables are related. The conceptual model represented in Figure 1 describes the relationship between tax morale on value-added tax compliance.

Tax Morale
- Perception
- Beliefs
- Ration Of VAT Pre-Filled

Value Added Tax Value Added Tax compliance
- Tax payments
- Returns filed

Independent Variable   **Dependent Variable**

Figure 1: Conceptual Framework

3.0 Methodology

The research used an explanatory research design, mainly because it is more consistent with the general objective of the study. The target population was 2,376 VAT-registered medium taxpayers in north of Nairobi tax district, Kenya (KRA, 2023). For this study, a questionnaire was used as the main tool for primary data collection from the sampled respondents. Cronbach's alpha was used to evaluate the unidimensionality of a set of scale items and compare the two scores obtained. Out of 342 respondents targeted, 274 questionnaires were correctly filled and returned. Indicating an 80% response rate.

According to Nunnally (1978), many factors can prevent measurements from being repeated perfectly. Cronbach's alpha was used to evaluate the unidimensionality of a set of scale items and compared the two scores obtained. Cronbach's alpha>0.7 indicates high levels of reliability. Table 1 shows that the Value Added Tax compliance had a Cronbach's alpha

=0.988>0.7 and tax morale Cronbach's alpha =0.933>0.7. The Cronbach's alpha showed that each of the responses for each item were found to be reliable.

Table 1: Test of Reliability of Questionnaire

Factor	Number of Items	Cronbach Alpha score	Conclusion
Tax Morale	5	0.933	Reliable
VAT tax compliance	5	0.988	Reliable

4.0 Results and Discussion

4.1 Descriptive statistics

4.1.1 Descriptive Statistics of Tax Morale

Table 2 illustrates I trust the government with my tax payments, and this encourages me to effectively comply with all tax requirements with a mean score of 3.80 and, a standard deviation of 1.085. My faith often encourages me to pay all my taxes as provided for in tax laws because it is the right thing to do with a mean score of 4.02, a standard deviation of 1.007. When I pay taxes, my contribution does not count due to misappropriation of tax revenue by the government with a mean score of 3.91 and, a standard deviation of 1.091. I feel that tax revenue is often lost due to corruption and that discourages me from being compliant with a mean score of 3.82, a standard deviation of 1.090 and I think the process of filing tax returns is too tedious, and that often discourages me with mean score of 4.17, standard deviation of 0.983.

Table 2: Descriptive Statistics Tax Morale

	N	Mean	Std. Deviation	Skewness	Kurtosis
I trust the government with my tax payments, and this encourages me to effectively comply with all tax requirements.	274	3.80	1.085	-.520	-.745
My faith often encourages me to pay all my taxes as provided for in tax laws because it is the right thing to do.		4.02	1.007	-.687	-.666
When I pay taxes, my contribution does not count due to misappropriation of tax revenue by the government.		3.91	1.091	-.586	-.853
I feel that tax revenue is often lost due to corruption and that discourages me from being compliant.		3.82	1.090	-.460	-.965
I think the process of filing tax returns is too tedious, and that often discourages me.		4.17	.983	-.838	.138
Aggregate Mean		**3.94**			

4.1.2 Descriptive statistics of Value added tax compliance

Table 3 illustrates: that I always file my VAT returns as stipulated by the law with a mean score of 3.94, and a standard deviation of 1.132. I register for new tax obligations as and when I attain registration criteria with a mean score of 4.01 and a standard deviation of 1.147. I compute and pay my VAT correctly and in good time as stipulated by the law with a mean score of 3.94 and, a standard deviation of 1.125. I file VAT returns voluntarily without being compelled to do so mean score of 3.98, and a standard deviation of 1.127. I always declare the correct amount with a mean score of 3.92 and, a standard deviation of 1.101

Table 3: descriptive statistics of Value added tax compliance

	N	Mean	Std. Deviation	Skewness	Kurtosis
I always file my VAT returns as stipulated by the law	274	3.94	1.132	-.686	-.736
I register for new tax obligations as and when I attain registration criteria.		4.01	1.147	-.785	-.667
I compute and pay my VAT correctly and in good time as stipulated by the law.		3.94	1.125	-.700	-.655
I file VAT returns voluntarily without being compelled to do so.		3.98	1.127	-.721	-.747
I always declare the correct amount.		3.92	1.101	-.645	-.740
Aggregate Mean		**3.96**			

4.2 Correlation Analysis

Correlation analysis is a statistical tool used to identify the direction of the relationship between variables in a study. Table 4 shows tax morale has a positive and significant correlation to VAT compliance up to 42.5%. This means that as tax morale increases the VAT compliance tends to increase.

Table 4: Correlations Statistics of Independent and Dependent Variable

	VAT Compliance	**Tax Morale**
VAT Compliance	1	0.425[**]
Tax Morale	0.425[**]	1

Correlation is significant at the 0.05 level (2-tailed).

4.3 Regression Analysis

The results in Table 5 indicated that Tax Morale had a positive correlation with VAT compliance up to 4.25% or (R= 0.425). The results reveal that Tax Morale caused a variation of 18% or (R^2=0.180 and adjusted R^2 =0.173) on Value Added Tax compliance.

Table 5: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.425[a]	.180	.173	.54670

a. Predictors: (Constant), Tax Morale _mean

The ANOVA was used to analyze the significance of the variation caused by Tax morale on VAT compliance. Table 6 indicates that there is an F statistic of 184.690 and P-value of 0.000<0.05 indicating that there is a significant variation caused by Tax morale on VAT compliance. The implication is that independent variable (Tax Morale) contributes significantly to changes in the dependent variable (VAT compliance). This shows that the model works and thus accounts for significantly more variance in the dependent variable than would be expected by chance.

Table 6: Analysis of Variance

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	87.174	1	87.174	184.690	.000[b]
	Residual	128.549	272	0.472		
	Total	215.723	273			

a. Dependent Variable: VAT compliance
b. Predictors: (Constant), Tax Morale

The hypothesis stated that Tax Morale has no significant effect on VAT compliance among medium taxpayers north of Nairobi tax district, Kenya. Tax invoice management system has a positive relationship effect on VAT compliance among small and medium taxpayers in the north of Nairobi tax district, Kenya. The results in Table 7 revealed that p-value was less than 0.05, ρ=0.000 which implies that relationship was statistically significant and therefore hypothesis was rejected.

Table 7: Regression Coefficients

Model		Standardized Coefficients		Unstandardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	0.790	0.252		3.135	0.001
	Tax Morale	0.173	0.067	0.195	2.582	0.003

a. Dependent Variable: VAT compliance

4.4 Discussion of the Findings

The study aimed to assess the influence of tax morale on Value Added Tax (VAT) compliance among medium taxpayers in Nairobi County, Kenya. The study found a positive and significant correlation between tax morale and VAT compliance. Regression analysis showed that tax morale positively affected VAT compliance (β=0.173, $p < 0.05$).

5.0 Conclusions

The findings indicate that tax morale positively influences Value Added Tax (VAT) compliance among medium taxpayers in Nairobi County, Kenya. The study concludes that when taxpayers have a positive attitude towards taxation, they are more likely to comply with VAT regulations. The significant correlation found underscores the motivational impact of tax morale on compliance behaviors. Tax authorities could consider strategies to bolster tax morale through transparency, fairness, and effective communication to foster greater compliance.

6.0 Recommendations

Based on the findings of the study the government of Kenya should allocate resources towards improving taxpayer services, including helplines, online portals, and advisory services. Future studies should be conducted on the effects of behavioral factors on VAT compliance.

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